

Legislative Audit Division

State of Montana



Report to the Legislature

February 1997

Financial-Compliance Audit

For the Two Fiscal Years Ended June 30, 1996

Department of Revenue

This report contains seven recommendations for improving the department's compliance with state law and policy. These recommendations relate to:

- **Accounting and fund placement.**
- **Property assessment procedures.**
- **Compliance with state laws.**
- **Seeking legislation to amend state law.**

**Direct comments/inquiries to:
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FINANCIAL-COMPLIANCE AUDITS

Financial-compliance audits are conducted by the Legislative Audit Division to determine if an agency's financial operations are properly conducted, the financial reports are presented fairly, and the agency has complied with applicable laws and regulations. In performing the audit work, the audit staff uses standards set forth by the American Institute of Certified Public Accountants and the United States General Accounting Office. Financial-compliance audit staff members hold degrees with an emphasis in accounting. Most staff members hold Certified Public Accountant (CPA) certificates.

Government Auditing Standards, the Single Audit Act of 1984 and Amendments of 1996, and OMB Circular A-128 require the auditor to issue certain financial, internal control, and compliance reports. This individual agency audit report is not intended to comply with these reporting requirements and is therefore not intended for distribution to federal grantor agencies. The Legislative Audit Division issues a statewide biennial Single Audit Report which complies with the above reporting requirements. The Single Audit Report for the two fiscal years ended June 30, 1995 has been issued. Copies of the Single Audit Report can be obtained by contacting:

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February 1997

The Legislative Audit Committee
of the Montana State Legislature:

This is our financial-compliance audit report on the Department of Revenue for the two fiscal years ending June 30, 1996. We issued a qualified opinion on the financial schedules of the department. Included in this report are seven recommendations concerning proper accounting and fund placement, property assessment procedures, compliance with state law, and seeking legislation to amend or clarify state law. The department's response is located at the end of the report.

We thank the director and staff for their assistance and cooperation throughout the audit.

Respectfully submitted,

"Signature on File"

Scott A. Seacat
Legislative Auditor

Legislative Audit Division

Financial-Compliance Audit

For the Two Fiscal Years Ended June 30, 1996

Department of Revenue

Members of the audit staff involved in this audit were Pearl M. Allen, Laurie Evans, Frieda Houser, Tori Hunthausen, Cindy S. Jorgenson, Jim Manning, Paul J. O'Loughlin, Vickie Rauser, and Kris Wilkinson.

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Appointed and Administrative Officials

Central Management

Mary Bryson, Director

Judy Paynter, Deputy Director

Dave Woodgerd, Chief Legal Counsel

Division Administrators

Judy Jones, Operations

Jeff Miller, Income and Miscellaneous Tax

Gary Blewett, Liquor

Mary Whittinghill, Property Assessment

Other Administrators

Don Hoffman, Natural Resource Tax, Bureau Chief

Lynn Chenoweth, Corporation Tax, Bureau Chief

Department of Revenue

This financial-compliance audit report contains the results of the audit for the two fiscal years ended June 30, 1996. The previous audit report contained 12 recommendations to the department. The department implemented 8. Two recommendations were not implemented, one addressing the regulation of cigarette prices, and the second analyzing the cost savings in shipping liquor to stores. The two remaining recommendations are no longer applicable.

The current audit report contains seven recommendations. Issues addressed in the recommendations include: accounting and fund placement; property assessment procedures; compliance with state laws; and, legislation to amend state law.

The first issue in the report concerns accounting for certain activity in the Agency Fund. We note that some activity would be more appropriately recorded in funds other than the Agency Fund. This would improve the financial disclosure of this activity and provide the users of the financial data more complete disclosure and a better understanding of the department's operations.

The next issue discusses the department's responsibilities for determining and assessing market value for various types or classes of property. The report contains three recommendations which address concerns regarding: 1) the valuation of agricultural lands; 2) procedures for valuing centrally assessed property; and 3) updating and verifying reality transfer certificates for residential properties.

The final issue relates to compliance with state laws or the need to seek legislation to amend state law. The report discusses transferring or depositing money in the General Fund, taxation of intangible property, and the distribution methodology for the state's Combined Oil and Gas Tax (COGT).

We issued a qualified opinion on the financial schedules contained in the report. This means the reader should use caution when relying on the presented financial information or the supporting information on the Statewide Budgeting and Accounting System.

Report Summary

The listing below serves as a means of summarizing the recommendations contained in the report, the departments' response thereto, and a reference to the supporting comments.

<u>Recommendation #1</u>	We recommend the department: A. Seek legislation to amend sections 15-36-324 and 325, MCA, which presently require deposit of state tax revenues in the Agency Fund. B. Work with Accounting Bureau of the Department of Administration to ensure proper fund placement of local government assistance activity.	10
	<u>Department Response:</u> Concur. See page B-3.	
<u>Recommendation #2</u>	We recommend the department implement a system to ensure agricultural lands are valued at 100 percent of productive capacity as required by state law.	12
	<u>Department Response:</u> Partially Concur. See page B-3.	
<u>Recommendation #3</u>	We recommend the department ensure all financial information is considered in the preparation of assessments for centrally assessed companies by documenting the decision process for including or excluding financial information in the assessment of market value.	13
	<u>Department Response:</u> Concur. See page B-4.	
<u>Recommendation #4</u>	We recommend the department evaluate the implementation of its guidelines for verifying realty transfer certificates to ensure consistency throughout the state.	15
	<u>Department Response:</u> Concur. See page B-4.	
<u>Recommendation #5</u>	We recommend the department transfer \$570,140 to the General Fund in accordance with section 15-35-108, MCA.	16
	<u>Department Response:</u> Concur. See page B-5.	
<u>Recommendation #6</u>	We recommend the department tax intangible property in accordance with state law.	16
	<u>Department Response:</u> Concur. See page B-5.	

Report Summary

Recommendation #7

We recommend the department seek legislation to amend the distribution methodology outlined in section 15-36-324, MCA, to comply with the intent of the legislature. 18

Department Response: Concur. See page B-5.

Introduction

Introduction

We performed a financial-compliance audit of the Department of Revenue for the two fiscal years ended June 30, 1996. The objectives of our audit were to:

1. Determine if the department complied with applicable state and federal laws and regulations.
2. Obtain an understanding of and, if appropriate, make recommendations for improvement in the internal and management controls of the department.
3. Determine the implementation status of prior audit recommendations.
4. Determine if the department's financial schedules present fairly the results of its operations for the two fiscal years ended June 30, 1996.

In accordance with section 5-13-307, MCA, we analyzed and disclosed the costs, if significant, of implementing recommendations contained in this report.

Department Organization and Functions

The Department of Revenue was created by the Executive Reorganization Act of 1971. The department's primary responsibilities are to ensure compliance with state tax laws; to assist taxpayers in fulfilling their obligations to the state; and to maximize the collection of taxpayer funds by maintaining an efficient and timely mechanism for collection and deposit of revenues. The department budget included approximately 648 full-time equivalent employees in fiscal year 1995-96. The department currently consists of the Director's Office and five divisions. The duties and functions of the office and divisions are described as follows:

Director's Office - provides management control, coordination of policy direction, strategic planning, and legal services that assist the tax and liquor programs in fulfilling their responsibilities. The legal function advises program staff and handles a large number of tax appeals before the State Tax Appeals Board as well as state courts. Research and information staff perform and publish studies concerning the impact on state and local revenue sources caused by legislative action, executive decisions, and changes in economic

Introduction

patterns. The director's office is funded with General, Special Revenue, and Proprietary Funds.

Operations Division - performs a variety of accounting, cashiering, fiscal control, mail receipt and distribution, purchasing, and budgeting services for all department programs. The division provides automated data and word processing, systems analysis, systems development and maintenance, data entry, computer operations support, technical support and research services for all divisions. The division is funded with General, Special Revenue and Proprietary Funds.

Liquor Division - controls the sale and distribution of alcoholic beverages and the licensing of manufacturers, wholesalers, and retailers of alcoholic beverages in Montana. The division is funded with General Fund to support the licensing program, and Proprietary Funds for the liquor administration program.

Chapter 530, Laws of 1995, revised the laws regarding the sale of liquor by providing for the conversion of employee-operated state liquor stores to agency liquor stores, and selling the liquor inventory owned by the state. As of June 30, 1995, the department calculated the dollar amount of inventory on hand for each agency liquor store in operation. The department then sent an invoice for the total value of inventory, payable in 16 even monthly payments, the first payment due 60 days from the date the statement was sent.

Income and Miscellaneous Tax Division - administers and enforces the Montana individual income tax laws, including employer and employee withholding and payroll taxes. The division is also responsible for administering miscellaneous taxes not administered by other divisions including tobacco, accommodations, inheritance, estate, emergency telephone and the collection of the Old Fund Liability Tax (OFLT). The division is funded with General and state Special Revenue Funds.

Corporation and Natural Resource Tax Division - administers various taxes including corporation license tax, oil and gas severance tax, coal severance tax, metal mines tax, gross and net proceeds tax, local government severance tax, combined oil and natural gas severance tax, electrical energy license tax and the resource indemnity and ground water assessment tax. The division also administers the royalty audit programs related to mineral production from state and federal lands located in Montana. The division is funded with General and state and federal Special Revenue Funds.

Property Assessment Division - performs property appraisal and assessment functions statewide. These functions include completing reappraisal of all real property in accordance with the statutory time schedule, assessing personal property each year, completing annual sales ratio studies, valuing new construction and land use changes, auditing property tax returns, and defending the department in tax appeals. There are state offices located in all 56 counties. The division is General Fund supported.

Prior Audit Recommendations

Prior Audit Recommendations

The financial-compliance audit report of the department for the two fiscal years ended June 30, 1994, contained 12 recommendations. We determined the department implemented eight and did not implement two prior recommendations as discussed below. The remaining two recommendations are no longer applicable.

Cigarette Minimum Pricing Statutes

In our prior report we recommended the department seek legislation to repeal laws which require them to regulate minimum pricing of cigarettes. Legislation was not introduced in the 1995 legislative session; however, personnel said the department submitted a request to the Governor's Task Force To Renew Montana Government to review the statutes and make a recommendation. Personnel said the Task Force did not review the cigarette minimum price statutes. The department is planning to seek assistance from the Legislative Audit Committee to sponsor legislation in the 1997 session and for these reasons we make no further recommendation.

Freight Charges for Shipment of Liquor

The second recommendation not implemented relates to the liquor division reviewing freight charges paid for shipment of liquor to liquor stores. Since our report was issued the trucking industry in Montana was deregulated and freight charges are no longer subject to review and approval by the Public Service Commission, allowing the department to contract for freight services. Therefore, we make no further recommendation at this time but will review the freight service contracts in our next audit.

Findings and Recommendations

Improper Accounting of Agency Fund Activity

In fiscal year 1995-96, the department used the Agency Fund to account for the following activities.

1. Dishonored Checks
2. Undistributed Dangerous Drug Tax
3. Protested Rail Road Car Company Tax
4. Protested Property Tax
5. Corporation Tax - Financial Institutions
6. Alcohol Tax - County Allocation
7. Local Government Severance Tax (LGST) - Oil and Gas (Pre-1995)
8. LGST - Oil and Gas (1995 production year)
9. Combined Oil and Gas Tax (COGT)

An Agency Fund is an account used to account for assets belonging to other individuals, governments, or funds. Agency funds are custodial in nature. The Agency Fund is one fund within the Fiduciary Fund type. Fiduciary Fund types include Expendable Trust Funds and Nonexpendable Trust Funds in addition to Agency Funds. The following table identifies the different accounting treatment of activities recorded in the various types of Fiduciary Funds.

Table 1

Fiduciary Funds Accounting

Accounting Treatment / Fund Type	Revenues Recorded	Expenditures Recorded	Property Held in Trust	Fund Balance	Trust Principal Reserved
Expendable Trust	YES	YES	NO	YES	NO
Nonexpendable Trust	YES	YES	NO	YES	YES
Agency Fund	NO	NO	YES	NO	NO

Activities 1 through 4, above, are appropriate Agency Fund activities because the assets are held for other funds. The remaining

Findings and Recommendations

five activities are not appropriately recorded in an Agency Fund and are discussed in the following sections.

Fund Placement By Law

Activities 8 and 9 above, are statutorily required to be deposited in the Agency Fund. Specifically, section 15-36-325, MCA, requires the LGST - Oil and Gas (1995 production year), to be deposited in the Agency Fund. In addition, section 15-36-324, MCA, requires 58.4 percent of the oil production taxes and 85.4 percent of the natural gas production taxes for the COGT, to be deposited in the Agency Fund. These tax revenues are state activity because the tax is levied by the state and state law dictates how the tax is distributed or expended. As noted in Table 1, an Agency Fund accounts for receipt and disbursement of assets as additions and deletions to property held in trust. As a result, \$27,861,431 of state tax revenues and local assistance expenditures are not properly reflected on the financial schedules. In order to properly disclose this activity, the department should seek legislation to amend the laws which place these moneys in the Agency Fund.

Administrative Fund Placement

Chapter 556, Laws of 1995, requires that unless otherwise specifically provided in statutes pertaining to the tax, the portion of taxes collected by the state that, pursuant to a statute, are to be allocated or distributed to local government entities shall be accounted for in a Fiduciary Fund type. In response to this law, the Accounting Bureau of the Department of Administration placed activities 5 through 7 above in Agency Funds within the fiduciary fund type. The department is not an agent nor is it holding assets for other entities; therefore, this financial activity should be recorded in an Expendable Trust Fund within the fiduciary fund type in order to properly account for the tax-related activity. Subsequent to its initial policy decision, the Accounting Bureau determined these activities should be in an Expendable Trust Fund. Consequently, this financial activity is included in the Expendable Trust Fund on the accompanying financial schedules.

Findings and Recommendations

Accounting Errors Within the Agency Fund Accounts

The department accounts for the COGT in two Agency Fund accounts. During our review of the two accounts we identified numerous accounting errors which occurred during the fiscal year-end period. These errors caused the assets and liabilities to be misstated in the oil and gas accounts by \$17,729,461 and \$8,313,852, respectively. The errors also result in an overstatement of additions to Property Held in Trust (PHIT) of \$26,043,312. Reductions to PHIT are overstated by \$13,063,937 and the June 30, 1996 PHIT balance is overstated by \$12,979,375. These errors resulted in the qualified opinion in the Independent Auditor's Report on page A-3

State law requires the department to input all the necessary transactions to the accounting system, before the accounts are closed at the end of the fiscal year, in accordance with generally accepted accounting principles. However, department procedures use the same Agency Fund account to track total tax collection and total tax distribution. The department records not only the total tax receivable and related distribution payable in the account, but also a separate receivable/payable for the portion allocated to the counties. This procedure results in an overstatement of receivables and payables. Had the proper fund been used to account for the activities discussed above, the errors may have been eliminated.

Conclusion

The COGT went into effect for fiscal year 1995-96. Prior to fiscal year 1995-96, activities 5 through 8 were accounted for in a state Special Revenue Fund. The movement of this activity to an Agency Fund prohibits the continued measurement of revenues and expenditures for these activities. However, accounting for this activity in an Expendable Trust Fund would allow the revenues and expenditures to be reflected on the department's financial records. Because of the number of issues concerning Agency Funds and accounting treatment within the Agency Funds, it is our intention in our upcoming Department of Administration audit, to look at these issues on a statewide basis.

Findings and Recommendations

Recommendation #1

We recommend the department:

- A. Seek legislation to amend sections 15-36-324 and 325, MCA, which presently require deposit of state tax revenues in the Agency Fund.**
- B. Work with Accounting Bureau of the Department of Administration to ensure proper fund placement of local government assistance activity.**

Property Assessments

The Property Assessment Division (division) of the Department of Revenue determines the assessed value of nine classes of taxable property. Property taxation laws require tax assessments be based on 100 percent of the property's market value. Market value for various classes of property is defined in state law.

We reviewed the division's methodology for assessing property values of the various classes of property. We identified concerns relating to assessing agricultural property and centrally assessed property at fair market value and the verification process used for realty transfer certificates. The following three sections discuss these issues in detail.

Agricultural Lands

State law requires agricultural lands, when valued for agricultural purposes, be assessed at 100 percent of productive capacity. The division measures productive capacity using a land use classification system. A grading system is included as a component of the land use classifications. Productive capacity grades range from 1 to 14, grade 1 is considered the highest grade of productive capacity. The division last completed statewide productivity capacity grading of agricultural lands in the 1970s. The division does not have a system to update productivity grades for agricultural lands. There have been numerous technological developments in the last 20 years which may have changed productivity levels assigned to agricultural land. It may be possible for two producers who had identically graded property as determined 20 years ago to currently have

Findings and Recommendations

different productive capacity today. This situation could result in inconsistent and inequitable taxation which is contrary to current law.

Department personnel stated they have no basis to determine if agricultural lands have changed productive capacity and are not aware of any inconsistent or inequitable taxation for agricultural property. However, because there is no system or process to update agricultural productivity capacity on a statewide basis, the department is unable to document if agricultural lands are currently assessed at 100 percent of productive capacity as required under state law.

Department personnel stated the department does not currently have the necessary resources to regrade agricultural lands. Officials stated there were several proposals to study agricultural valuation/classification in the 1993 and 1995 legislative sessions which were not passed. According to department officials, the division's regrading of agricultural lands could be accomplished using a variety of techniques. There is a wide range of options available to develop and implement a system to monitor the productive capacity of agricultural land. These options range from a total regrading of all parcels to a statistical sample of parcels to determine if productive capacities of lands have significantly changed since the last statewide grading.

The cost to implement a total statewide regrading could be prohibitive. Department officials stated it would require two additional persons per county over five years to implement a manual statewide reappraisal for agricultural lands. Total cost is estimated at up to \$13.5 million. Another option would be to obtain information from the Department of Agriculture, Hail Insurance Program or other agriculture insurance or subsidy programs where production is a key to participation and benefit payments. Comparing the average crop yield insurance information with selected parcels to the productive capacity grading for the same parcel would provide a basis to determine if productive capacity has changed in the last 20 years. Development of a statistical model would provide a basis to

Findings and Recommendations

determine if the current agricultural values are in compliance with state law.

Recommendation #2

We recommend the department implement a system to ensure agricultural lands are valued at 100 percent of productive capacity as required by state law.

Centrally Assessed Property

The Centrally Assessed Property Bureau (bureau) assesses the market value of property owned by companies operating on a statewide or national basis, including airlines, railroads, and utility companies. The bureau uses information from company financial statements in its determination of market value. We found the bureau did not document, in all cases, its decision process for including or excluding specific financial information in the assessment of market value.

State law requires the bureau to assess all property subject to taxation and to equalize values. We found one instance where the bureau did not document the decision to exclude \$10,841,000 in rental payments from the associated property assessment calculations for calendar year 1994. When questioned, the assessor who completed the calculation could not remember including the information in the calculation and was unable to provide the documentation to make the determination on the proper treatment of the financial information. In April of 1996, Centrally Assessed Property Bureau assessors calculated the assessment for the same property for calendar year 1995. At this time they obtained documentation of the rental payments and determined the appropriate treatment for the current assessment calculation. From this information they were also able to confirm the appropriate treatment of the \$10,841,000 in rental payments for the previous year's assessment. This confirmation did not change the assessment made for the previous year.

Findings and Recommendations

Recommendation #3

We recommend the department ensure all financial information is considered in the preparation of assessments for centrally assessed companies by documenting the decision process for including or excluding financial information in the assessment of market value.

Realty Transfer Certificates

The Property Assessment and Appraisal Division assesses all residential property in the state. The division uses two techniques for assessment for residential property, the cost approach and the market modeling approach. Property characteristics such as square footage of lot and residence, numbers of bedrooms, plumbing fixtures, quality of materials, condition of home, basement types and finishes, garage type and finish are used in both approaches as the basis of market value. The information must be accurate to ensure the market value is appropriately calculated and the values are equalized throughout the state as required by state law.

Property Assessment guidelines for sales verification outline procedures which include verification of property characteristics. The guidelines state the assigned appraiser will conduct a field review for each potentially valid sale. Field review includes verification of property characteristics as of the day of the sale and written verification of the sales information on the realty transfer certificate (RTC) from the homeowner. Guidelines state at a minimum, every potentially valid sale which has not been physically reviewed within a one year prior to the date of the sale should be re-inspected. This procedure ensures the data used in the market modeling process is available and current when the assessment process is completed. The procedure also ensures correction of errors found in the property characteristics and adjustment of market values in a timely manner.

We interviewed several regional field managers concerning the procedures they use to verify property characteristics when a residence is sold. We found the number of realty transfer

Findings and Recommendations

certificates received yearly in a region varied widely, from over 5,000 in the more populated regions to 1,200 in other areas of the state. We found all regions review realty transfer certificates. A sales verification letter is sent to the buyer of the residence asking for confirmation of the sale. However, the procedures used to verify the property characteristics at the time of the sale varied. We found less populated counties in one region receive up to 90 percent of the sales verification letters back and do field reviews including confirmation of the physical characteristics on the residences. Another county estimates it receives 50 percent to 60 percent of the sales verification letters back. Personnel in this county stated they do not complete any field reviews of the residences to confirm physical characteristics. The variances in the procedures used to verify the property characteristics may produce valuation inequities.

Department personnel stated the computer assisted mass appraisal system does not require 100 percent verification of property characteristics at the time of sale to be statistically valid. Department officials should reevaluate the necessity of verifying all valid sales given available resources. In some counties an additional letter is sent with the sales verification letter requesting the buyer confirm the physical characteristics of the residence. This tool could be used in all counties to supplement field reviews.

Division personnel indicated they were behind in the processing of sales verification information due to a lack of staff. The 1993 Legislature reduced the Property Assessment Division by 72.3 full time equivalent positions. The division has recently reorganized which will allow it to shift appraisers between locations based on work loads and priorities. The division also recently lifted a hiring freeze and is currently in the process of filling vacant positions. Division personnel stated these additional resources were used to ensure in the sales verification process was complete prior to implementing the 1996 reappraisal.

Prior to reorganization in 1995 the division had three audit personnel who verified the assessment and appraisal offices followed division procedures. The auditors' role was revised in January 1996 and became the Quality Performance Project Team. The purpose of

Findings and Recommendations

the team is to review the accuracy, consistency and overall quality of the reappraisal efforts. Division personnel indicate the team reviewed the sales verification process used in the 1996 reappraisal.

Recommendation #4

We recommend the department evaluate the implementation of its guidelines for verifying realty transfer certificates to ensure consistency throughout the state.

Coal Severance Tax - Transfer to General Fund

The department is responsible for collecting and distributing the coal severance taxes paid on coal produced in the state. The department recorded coal severance tax revenues of \$42,510,339 and \$35,209,540 on the state's accounting system during fiscal years 1994-95 and 1995-96, respectively. Section 15-35-108, MCA, outlines the methodology the department must follow in distributing these revenues, and requires the unspent cash balance remaining in the special revenue account at the end of each fiscal year to be deposited in the General Fund.

We reviewed the department's accounting records and determined the Special Revenue Fund account had an unspent cash balance of \$1,570,140 at fiscal year end 1995-96. According to department personnel, the legislature provided the Coal Board with a biennial appropriation of \$1,000,000 out of the account to make grants for impacts associated with the development of the Bull Mountain Mine. The Coal Board did not request any funding during fiscal year 1995-96. Because the Coal Board can request their funding any time prior to June 30, 1997, department personnel were uncertain how much of the cash balance could be transferred to the General Fund and as a result did not make the required transfer.

We believe the department should retain \$1,000,000 in cash in the Special Revenue Fund account to meet the Coal Board's funding needs during fiscal year 1996-97. The remaining \$570,140 would be available for transfer in accordance with section 15-35-108,

Findings and Recommendations

MCA. At the end of fiscal year 1996-97, the entire cash balance remaining in the account should be transferred to the General Fund.

Recommendation #5

We recommend the department transfer \$570,140 to the General Fund in accordance with section 15-35-108, MCA.

Taxation of Intangible Property

The previous audit report included a disclosure issue, discussing the taxation of certain intangible assets including patents, copyrights, commercial retail franchises, and liquor licenses. Currently, the department is not specifically identifying and taxing these assets.

The Constitution provides that property is to be taxed in the manner provided by law, and the legislature has established a broad system of taxation. All property is subject to taxation unless specifically exempt. Section 15-1-101, MCA, defines the term “property” to include “. . .franchises, and all other matters and things, real, personal, and mixed, capable of private ownership.” While not specifically identified in a tax class, the law provides that franchises and other intangible property “capable of private ownership” should be taxed as class eight property.

To determine whether an intangible property is subject to taxation, a case by case determination must be made as to whether the property has actual independent monetary value. Department officials believe the department is meeting its responsibility in administering property tax laws. While officials agree that certain intangible property should be taxed, they believe the department is addressing taxing intangibles, as practical. Officials explain the department is moving cautiously into the intangibles without getting into litigation.

Recommendation #6

We recommend the department tax intangible property in accordance with state law.

Combined Oil & Gas Production Tax Distribu- tion Percentages

Chapter 451, Laws of 1995, replaced the following taxes on oil and natural gas production with the COGT:

- Local Government Severance tax
- Privilege and License tax.
- State Severance tax.
- Net Proceeds tax.
- Resource Indemnity and Groundwater Assessment tax.

In addition to establishing the tax rates to be applied to oil and natural gas production, Chapter 451 outlines the methodology to be used in distributing the tax revenues among local governments and state accounts. This distribution methodology was codified as section 15-36-324, MCA.

The legislature passed three other bills affecting the distribution methodology set forth in section 15-36-324, MCA. Chapters 571, 573, and 581, Laws of 1995, relate to either the State Severance or Privilege and License taxes. Each contained coordination instructions directing the department to, by rule, change the distribution formula codified in section 15-36-324, MCA, in order to consider the changes made through Chapters 571, 573, and 581. The department complied with the coordination instructions and adopted a new distribution formula in the Administrative Rules of Montana (ARM). The department used the methodology outlined in the ARM to distribute the Combined Oil & Gas Production Taxes received during fiscal year 1995-96. However, the distribution in the ARM conflicts with section 15-36-324, MCA.

Based on our review of the distribution formula adopted by the department, the department has complied with the intent of the legislature. However, state law cannot be amended through administrative rule. The department should seek legislation to amend the distribution methodology outlined in section 15-36-324, MCA, to ensure state law reflects the intended disposition of the Combined Oil & Gas Production tax revenues.

Findings and Recommendations

Recommendation #7

We recommend the department seek legislation to amend the distribution methodology outlined in section 15-36-324, MCA, to comply with the intent of the legislature.

Independent Auditor's Report & Agency Financial Schedules

LEGISLATIVE AUDIT DIVISION

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Deputy Legislative Auditors:
Jim Pellegrini, Performance Audit
James Gillett, Financial-Compliance Audit

INDEPENDENT AUDITOR'S REPORT

The Legislative Audit Committee
of the Montana State Legislature:

We have audited the accompanying financial schedules of the Department of Revenue for each of the two fiscal years ended June 30, 1995 and 1996, as shown on pages A-5 through A-23. The information contained in these financial schedules is the responsibility of the department's management. Our responsibility is to express an opinion on these financial schedules based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial schedules are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosure in the financial schedules. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in note 1, the financial schedules are presented on a comprehensive basis of accounting other than generally accepted accounting principles. The schedules are not intended to be a complete presentation and disclosure of the department's assets, liabilities and cash flows.

The department incorrectly reported activity during the fiscal year 1995-96 year end closing period which resulted in some activity being recorded twice in the Agency Fund. As a result of these errors, for fiscal year 1995-96: additions to property held in trust is overstated by \$26,043,312; reductions to property held in trust is overstated by

\$13,063,937; and, property held in trust at June 30, 1996 is overstated by \$12,979,375 on the Schedule of Changes in Fund Balances & Property Held In Trust.

In our opinion, except for the effect on the Agency Fund described in the preceding paragraph, the financial schedules referred to above present fairly, in all material respects, the results of operations and changes in fund balances and property held in trust of the department for the two years ended June 30, 1995 and 1996, in conformity with the basis of accounting described in note 1.

Respectfully submitted,

“Signature on File”

James Gillett, CPA
Deputy Legislative Auditor

October 29, 1996

DEPARTMENT OF REVENUE
SCHEDULE OF CHANGES IN FUND BALANCES & PROPERTY HELD IN TRUST
FOR THE TWO FISCAL YEARS ENDED JUNE 30, 1996

	General	Special	Debt	Capital			Expendable	Nonexpendable
	Fund	Revenue	Service	Projects	Enterprise	Agency	Trust	Trust
	Funds	Funds	Funds	Funds	Funds	Funds	Funds	Funds
FUND BALANCE: July 1, 1994	\$ 0	\$ 23,445,739	\$ (1,296,713)	\$ 74,883	\$ 2,727,877	\$ 0	\$ 0	\$ 540,692,356
PROPERTY HELD IN TRUST: July 1, 1994						8,417,107		
ADDITIONS								
Fiscal Year 1994-95								
Budgeted Revenues & Transfers In (Note 12)	484,498,140	151,115,078	49,100,257	2,336,089	50,625,915			62,106,626
Nonbudgeted Revenues & Transfers In	1,323,408	1,382,149	29,167		37,640		1,448,319	21,246,643
Prior Year Revenues Adjustments	5,442,190	2,795,913	863,430	58,394	254,601			1,441,803
Prior Year Transfer-In Adjustments	(17,852)	17,894			(2,893)			
Direct Entries to Fund Balance							29,913	
Prior Year Expenditure Adjustments	83,625							
Additions to Property Held in Trust						12,374,557		
Fiscal Year 1995-96								
Budgeted Revenues & Transfers In (Note 12)	745,259,018	51,960,414	50,570,597	6,632,130	98,788,827		11,554,858	72,766,267
Nonbudgeted Revenues & Transfers In (Note 11)	10,752,454	1,280,731	(13,662)		87,496		17,409,960	18,684,572
Prior Year Revenues Adjustments			639,130		1,725,767			
Prior Year Transfer-In Adjustments	(12,591)							
Prior Year Expenditure Adjustments					11,205			
Direct Entries to Fund Balance (Note 7)					7,900,574		4,706,075	
Additions to Property Held in Trust						63,160,155		
Total Additions	1,247,328,392	208,552,179	101,188,919	9,026,613	159,429,132	75,534,712	35,149,125	176,245,911
REDUCTIONS								
Fiscal Year 1994-95								
Budgeted Expenditures & Transfers Out	38,207,034	41,683,532			49,208,838			
Prior Year Expenditures								
Support to State of Montana	453,122,477							
Nonbudgeted Expenditures & Transfers Out					748,548		1,430,881	58,742,754
Prior Year Expenditure Adjustments		48,079			6,893			
Nonbudgeted Prior Year Expenditure Adjustments					99,321			
Cash Transfers Out (Note 5)		120,362,494	48,266,601	2,404,872	495,071			14,811,026
Direct Entries to Fund Balance		5,414						
Prior Year Transfer Out Adjustments					(2,850)			
Reductions to Property Held in Trust						9,950,771		

Fiscal Year 1995-96								
Budgeted Expenditures & Transfers Out	62,639,066	3,256,555			50,503,038			
Prior Year Expenditures	9,260							
Support to State of Montana	690,327,192							
Nonbudgeted Expenditures & Transfers Out		777,066			4,635,378		33,626,499	69,023,244
Prior Year Expenditure Adjustments	17,192	14,166						
Cash Transfers Out (Note 5)		50,141,259	54,105,124	5,631,466	51,183,840			14,566,171
Direct Entries to Fund Balance (Note 7)	583,939	5,870,464						
Prior Year Revenue Adjustments	2,422,232	313,915						544,954
Reductions to Property Held in Trust						16,089,547		
Total Reductions	<u>1,247,328,392</u>	<u>222,472,944</u>	<u>102,371,725</u>	<u>8,036,338</u>	<u>156,878,077</u>	<u>26,040,318</u>	<u>35,057,380</u>	<u>157,688,149</u>
FUND BALANCE: June 30, 1996	\$ <u>0</u>	\$ <u>9,524,974</u>	\$ <u>(2,479,519)</u>	\$ <u>1,065,158</u>	\$ <u>5,278,932</u>	\$ <u>0</u>	\$ <u>91,745</u>	\$ <u>559,250,118</u>
PROPERTY HELD IN TRUST: June 30, 1996						\$ <u>57,911,501</u>		

This schedule is prepared from the Statewide Budgeting and Accounting System. Additional information is provided in the notes to the financial schedules beginning on page A-15.

DEPARTMENT OF REVENUE
SCHEDULE OF TOTAL REVENUES, TRANSFERS IN & OTHER ADDITIONS
FOR THE FISCAL YEAR ENDED JUNE 30, 1996

	General Fund	Special Revenue Funds	Debt Service Funds	Capital Projects Funds	Enterprise Funds	Expendable Trust Funds	Nonexpendable Trust Funds	Total
TOTAL REVENUES BY CLASS								
Licenses & Permits	\$ 6,594,410	\$ 310,802			\$ 1,526,026			\$ 8,431,238
Taxes	665,391,435	37,863,924	\$ 51,196,065	\$ 6,632,130	58,308,407	\$ 27,519,657	\$ 19,825,259	866,736,877
Charges for Services	5,170	2,114,310			6,880			2,126,360
Investment Earnings						292,016	52,396,054	52,688,070
Fines & Forfeits	(1,159)				36,866			35,707
Federal Indirect Cost Recoveries	14,814							14,814
Sale of Documents and Merchandise	(85)				40,713,030			40,712,945
Miscellaneous	19,993				10,881			30,874
Grants, Contracts & Donations	900	115,148				932,402		1,048,450
Other Financing Sources	56,592,220	12,296,979				220,743	18,684,572	87,794,514
Federal (Note 9)	24,958,951	226,067						25,185,018
Total Revenues	<u>753,576,649</u>	<u>52,927,230</u>	<u>51,196,065</u>	<u>6,632,130</u>	<u>100,602,090</u>	<u>28,964,818</u>	<u>90,905,885</u>	<u>1,084,804,867</u>
Less: Nonbudgeted Revenues & Transfers In	10,752,454	1,280,731	(13,662)		87,496	17,409,960	18,684,572	48,201,551
Prior-Year Revenue Adjustments	<u>(2,434,823)</u>	<u>(313,915)</u>	<u>639,130</u>		<u>1,725,767</u>		<u>(544,954)</u>	<u>(928,795)</u>
Actual Budgeted Revenues	745,259,018	51,960,414	50,570,597	6,632,130	98,788,827	11,554,858	72,766,267	1,037,532,111
Estimated Revenues	762,681,504	49,837,188	52,713,000	7,718,000	98,367,000	13,573,000	74,288,006	1,059,177,698
Budgeted Revenues Over (Under) Estimated	<u>\$ (17,422,486)</u>	<u>\$ 2,123,226</u>	<u>\$ (2,142,403)</u>	<u>\$ (1,085,870)</u>	<u>\$ 421,827</u>	<u>\$ (2,018,142)</u>	<u>\$ (1,521,739)</u>	<u>\$ (21,645,587)</u>
BUDGETED REVENUES OVER (UNDER) ESTIMATED BY CLASS								
Licenses & Permits	\$ 582,410	\$ 6,464			\$ (522,974)			\$ 65,900
Taxes (Note 11)	(22,021,781)	(704,458)	\$ (2,142,403)	\$ (1,085,870)	(2,443,477)	\$ (2,018,142)	\$ (3,952,378)	(34,368,509)
Charges for Services	(306)	870,294			(120)			869,868
Investment Earnings							2,430,639	2,430,639
Fines & Forfeits		(4)			(2,984)			(2,988)
Sale of Documents and Merchandise	(970)				3,391,382			3,390,412
Grants, Contracts & Donations	(600)	(10,504)						(11,104)
Other Financing Sources	2,846,810	1,970,845						4,817,655
Federal	1,171,951	(9,411)						1,162,540
Budgeted Revenues Over (Under) Estimated	<u>\$ (17,422,486)</u>	<u>\$ 2,123,226</u>	<u>\$ (2,142,403)</u>	<u>\$ (1,085,870)</u>	<u>\$ 421,828</u>	<u>\$ (2,018,142)</u>	<u>\$ (1,521,739)</u>	<u>\$ (21,645,587)</u>

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DEPARTMENT OF REVENUE								
SCHEDULE OF TOTAL REVENUES, TRANSFERS IN & OTHER ADDITIONS								
FOR THE FISCAL YEAR ENDED JUNE 30, 1995								
	General Fund	Special Revenue Funds	Debt Service Funds	Capital Projects Funds	Enterprise Funds	Expendable Trust Funds	Nonexpendable Trust Funds	Total
TOTAL REVENUES BY CLASS								
Licenses & Permits	\$ 12,872	\$ 6,437,577			\$ 1,526,963			\$ 7,977,412
Taxes	453,401,399	130,606,399	\$ 49,992,854	\$ 2,394,483	10,249,500		\$ 23,822,697	670,467,332
Charges for Services	5,791	2,078,830			6,483			2,091,104
Investment Earnings		281,791					39,720,274	40,002,065
Fines & Forfeits	984	(206)			59,242			60,020
Federal Indirect Cost Recoveries	21,487							21,487
Sale of Documents and Merchandise	50				39,071,319			39,071,369
Miscellaneous	(1,970)				4,649	\$ 1,241,858		1,244,537
Grants, Contracts & Donations		112,407				(5,515)		106,892
Other Financing Sources	37,805,273	15,564,302			(2,892)	211,976	21,252,101	74,830,760
Federal		229,934						229,934
Total Revenues	<u>491,245,886</u>	<u>155,311,034</u>	<u>49,992,854</u>	<u>2,394,483</u>	<u>50,915,264</u>	<u>1,448,319</u>	<u>84,795,072</u>	<u>836,102,912</u>
Less: Nonbudgeted Revenues & Transfers In	1,323,408	1,382,149	29,167		37,640	1,448,319	21,246,643	25,467,326
Prior-Year Revenues Adjustments	<u>5,424,338</u>	<u>2,813,807</u>	<u>863,430</u>	<u>58,394</u>	<u>251,709</u>		<u>1,441,803</u>	<u>10,853,481</u>
Actual Budgeted Revenues	484,498,140	151,115,078	49,100,257	2,336,089	50,625,915		62,106,626	799,782,105
Estimated Revenues	<u>475,732,109</u>	<u>137,593,156</u>	<u>46,500,000</u>	<u>2,132,000</u>	<u>52,513,000</u>		<u>78,238,005</u>	<u>792,708,270</u>
Budgeted Revenues Over(Under) Estimated	<u>\$ 8,766,031</u>	<u>\$ 13,521,922</u>	<u>\$ 2,600,257</u>	<u>\$ 204,089</u>	<u>\$ (1,887,085)</u>	<u>\$ 0</u>	<u>\$ (16,131,379)</u>	<u>\$ 7,073,835</u>
BUDGETED REVENUES OVER(UNDER) ESTIMATED BY CLASS								
Licenses & Permits	\$ 872	\$ 881,403			\$ 76,765			\$ 959,040
Taxes	28,373,317	9,060,368	\$ 2,600,257	\$ 204,089	(1,748,650)		\$ (949,115)	37,540,266
Charges for Services	(331)	417,505			(517)			416,657
Investment Earnings							(15,182,264)	(15,182,264)
Fines & Forfeits		(4)			19,242			19,238
Sale of Documents and Merchandise	(950)				(233,925)			(234,875)
Grants, Contracts & Donations		(27,664)						(27,664)
Other Financing Sources	(19,606,877)	3,178,231						(16,428,646)
Federal		12,083						12,083
Budgeted Revenues Over (Under) Estimated	<u>\$ 8,766,031</u>	<u>\$ 13,521,922</u>	<u>\$ 2,600,257</u>	<u>\$ 204,089</u>	<u>\$ (1,887,085)</u>		<u>\$ (16,131,379)</u>	<u>\$ 7,073,835</u>

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DEPARTMENT OF REVENUE
SCHEDULE OF TOTAL EXPENDITURES, TRANSFERS OUT, & OTHER REDUCTIONS BY OBJECT BY PROGRAM
FOR THE FISCAL YEAR ENDED JUNE 30, 1996

PROGRAM EXPENDITURES BY OBJECT	Directors Office	Operations Division	Liquor Division	Income Tax	Corporation Tax	Property Valuation	Total
Personal Services							
Salaries	\$ 664,957	\$ 1,595,358	\$ 1,247,621	\$ 2,596,291	\$ 855,767	\$ 8,280,333	\$ 15,240,327
Other Compensation	248		394,992	1,552			396,792
Employee Benefits	134,820	434,392	583,851	700,558	222,727	2,309,269	4,385,617
Personal Services-Other			(281,135)				(281,135)
Total	<u>800,025</u>	<u>2,029,750</u>	<u>1,945,329</u>	<u>3,298,401</u>	<u>1,078,494</u>	<u>10,589,602</u>	<u>19,741,601</u>
Operating Expenses							
Services	155,143	189,580	187,047	1,285,973	231,864	949,160	2,998,767
Supplies & Materials	44,761	72,712	44,197	111,944	25,250	355,325	654,189
Communications	19,685	17,672	67,275	381,660	41,893	521,551	1,049,736
Travel	17,248	10,660	8,562	36,276	124,275	185,202	382,223
Rent	25,905	59,824	182,507	117,781	28,191	131,177	545,385
Utilities			53,429			516	53,945
Repair & Maintenance	7,417	57,618	47,975	18,626	55,907	444,488	632,031
Other Expenses	13,348	23,982	5,084,476	14,711	23,844	35,496	5,195,857
Goods Purchased for Resale			27,693,664				27,693,664
Total	<u>283,507</u>	<u>432,048</u>	<u>33,369,132</u>	<u>1,966,971</u>	<u>531,224</u>	<u>2,622,915</u>	<u>39,205,797</u>
Equipment and Intangible Assets							
Equipment	19,497	283,877	(53,101)	54,582	14,405	105,516	424,776
Total	<u>19,497</u>	<u>283,877</u>	<u>(53,101)</u>	<u>54,582</u>	<u>14,405</u>	<u>105,516</u>	<u>424,776</u>
Local Assistance							
From State Sources		3,056,042	1,574,679	195,999	31,350,045	12,843,383	49,020,148
Total		<u>3,056,042</u>	<u>1,574,679</u>	<u>195,999</u>	<u>31,350,045</u>	<u>12,843,383</u>	<u>49,020,148</u>
Benefits and Claims (Note 8)							
From State Sources				21,482,063		5,288,671	26,770,734
Total				<u>21,482,063</u>		<u>5,288,671</u>	<u>26,770,734</u>
Transfers							
Accounting Entity Transfers		50,714,541	18,166,943	1,108,752	19,085,769		89,076,005
Total		<u>50,714,541</u>	<u>18,166,943</u>	<u>1,108,752</u>	<u>19,085,769</u>		<u>89,076,005</u>
Debt Service							
Loans		6,678	7,526	2,276		20,351	36,831
Installment Purchases						205,106	205,106
Total		<u>6,678</u>	<u>7,526</u>	<u>2,276</u>		<u>225,457</u>	<u>241,937</u>

Total Program Expenditures	\$ <u>1,103,029</u>	\$ <u>56,522,936</u>	\$ <u>55,010,508</u>	\$ <u>28,109,044</u>	\$ <u>52,059,937</u>	\$ <u>31,675,544</u>	\$ <u>224,480,998</u>
PROGRAM EXPENDITURES BY FUND							
General Fund	\$ 978,235	\$ 2,388,103	\$ 259,272	\$ 26,022,799	\$ 1,368,900	\$ 31,638,948	\$ 62,656,257
Special Revenue Fund	4,708	1,445,899		977,493	1,583,089	36,596	4,047,785
Enterprise Fund	120,086	255,890	54,751,236				55,127,212
Expendable Trust Fund		1,718,503		1,108,752	30,799,244		33,626,499
Nonexpendable Trust Fund		50,714,541			18,308,703		69,023,244
Total Program Expenditures	<u>1,103,029</u>	<u>56,522,936</u>	<u>55,010,508</u>	<u>28,109,044</u>	<u>52,059,936</u>	<u>31,675,544</u>	<u>224,480,997</u>
Less: Nonbudgeted Expenditures		52,433,043	4,635,378	1,108,752	49,885,013		108,062,186
Prior-Year Expenditure Adjustments	<u>801</u>	<u>15,653</u>	<u>(11,204)</u>	<u>12,435</u>		<u>2,468</u>	<u>20,153</u>
Actual Budgeted Expenditures	1,102,228	4,074,240	50,386,334	26,987,857	2,174,923	31,673,076	116,398,658
Budget Authority	1,168,423	4,085,600	52,863,392	26,996,370	2,185,932	39,385,176	126,684,893
Unspent Budget Authority	<u>\$ 66,195</u>	<u>\$ 11,360</u>	<u>\$ 2,477,058</u>	<u>\$ 8,513</u>	<u>\$ 11,009</u>	<u>\$ 7,712,100</u>	<u>\$ 10,286,235</u>
UNSPENT BUDGET AUTHORITY BY FUND							
General Fund	\$ 66,195	\$ 779	\$ 2,640	\$ 2,721	\$ 413	\$ 7,708,696	\$ 7,781,444
Special Revenue Fund		10,581		5,792	10,596	3,404	30,373
Enterprise Fund			2,474,418				2,474,418
Unspent Budget Authority	<u>\$ 66,195</u>	<u>\$ 11,360</u>	<u>\$ 2,477,058</u>	<u>\$ 8,513</u>	<u>\$ 11,009</u>	<u>\$ 7,712,100</u>	<u>\$ 10,286,235</u>

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DEPARTMENT OF REVENUE
SCHEDULE OF TOTAL EXPENDITURES, TRANSFERS OUT & OTHER REDUCTIONS BY OBJECT BY PROGRAM
FOR THE FISCAL YEAR ENDED JUNE 30, 1995

PROGRAM EXPENDITURES BY OBJECT	<u>Directors Office</u>	<u>Operations Division</u>	<u>Liquor Division</u>	<u>Income Tax</u>	<u>Corporation Tax</u>	<u>Property Valuation</u>	<u>Total</u>
Personal Services							
Salaries	\$ 657,608	\$ 1,620,807	\$ 2,134,970	\$ 2,570,455	\$ 835,439	\$ 7,688,501	\$ 15,507,780
Other Compensation			12,967	150			13,117
Employee Benefits	143,160	435,556	635,824	716,089	217,790	2,279,557	4,427,976
Personal Services-Other			20,062				20,062
Total	<u>800,768</u>	<u>2,056,363</u>	<u>2,803,823</u>	<u>3,286,694</u>	<u>1,053,229</u>	<u>9,968,058</u>	<u>19,968,935</u>
Operating Expenses							
Services	90,003	170,417	2,032,188	789,727	135,696	477,731	3,695,762
Supplies & Materials	24,028	36,990	101,035	95,643	25,660	258,581	541,937
Communications	20,433	15,844	107,060	324,762	32,838	405,532	906,469
Travel	8,326	145	23,497	20,954	120,791	117,276	290,989
Rent	20,242	53,240	558,860	91,581	26,994	106,758	857,675
Utilities			84,978			515	85,493
Repair & Maintenance	21,285	37,434	91,358	38,974	19,235	143,767	352,053
Other Expenses	7,447	10,359	925,706	15,376	4,710	30,033	993,631
Goods Purchased for Resale			27,268,951				27,268,951
Total	<u>191,764</u>	<u>324,429</u>	<u>31,193,633</u>	<u>1,377,017</u>	<u>365,924</u>	<u>1,540,193</u>	<u>34,992,960</u>
Equipment and Intangible Assets							
Equipment	8,547	13,804	(31,228)	34,571	4,536	208,492	238,722
Intangible Assets			3,001	4,750			7,751
Total	<u>8,547</u>	<u>13,804</u>	<u>(28,227)</u>	<u>39,321</u>	<u>4,536</u>	<u>208,492</u>	<u>246,473</u>
Local Assistance							
From State Sources		2,909,530			37,809,954	18,382,739	59,102,223
From Other Income Sources					17,164		17,164
Total		<u>2,909,530</u>			<u>37,827,118</u>	<u>18,382,739</u>	<u>59,119,387</u>
Transfers							
Accounting Entity Transfers		37,976,056	15,382,910	1,430,881	20,766,698		75,556,545
Total		<u>37,976,056</u>	<u>15,382,910</u>	<u>1,430,881</u>	<u>20,766,698</u>		<u>75,556,545</u>
Debt Service							
Installment Purchases						205,104	205,104
Total						<u>205,104</u>	<u>205,104</u>
Total Program Expenditures	\$ <u>1,001,079</u>	\$ <u>43,280,182</u>	\$ <u>49,352,139</u>	\$ <u>6,133,913</u>	\$ <u>60,017,505</u>	\$ <u>30,304,586</u>	\$ <u>190,089,404</u>

PROGRAM EXPENDITURES BY FUND

General Fund	\$ 826,675	\$ 1,762,509		\$ 4,066,611	\$ 1,163,028	\$ 30,304,586	\$ 38,123,409
Special Revenue Fund		3,007,410		636,421	38,087,779		41,731,610
Enterprise Fund	174,404	534,207	\$ 49,352,139				50,060,750
Expendable Trust Fund				1,430,881			1,430,881
Nonexpendable Trust Fund		37,976,056			20,766,698		58,742,754
Total Program Expenditures	<u>1,001,079</u>	<u>43,280,182</u>	<u>49,352,139</u>	<u>6,133,913</u>	<u>60,017,505</u>	<u>30,304,586</u>	<u>190,089,404</u>
Less: Nonbudgeted Expenditures & Transfers Out		37,976,056	748,548	1,430,881	20,766,698		60,922,183
Prior-Year Expenditure Adjustments	<u>3,771</u>	<u>35,481</u>	<u>103,364</u>	<u>2,007</u>	<u>552</u>	<u>(77,357)</u>	<u>67,818</u>
Actual Budgeted Expenditures	997,308	5,268,645	48,500,227	4,701,025	39,250,255	30,381,943	129,099,403
Budget Authority	<u>1,020,066</u>	<u>5,357,843</u>	<u>53,033,618</u>	<u>4,897,693</u>	<u>49,185,887</u>	<u>30,415,547</u>	<u>143,910,654</u>
Unspent Budget Authority	\$ <u><u>22,758</u></u>	\$ <u><u>89,198</u></u>	\$ <u><u>4,533,391</u></u>	\$ <u><u>196,668</u></u>	\$ <u><u>9,935,632</u></u>	\$ <u><u>33,604</u></u>	\$ <u><u>14,811,251</u></u>

UNSPENT BUDGET AUTHORITY BY FUND

General Fund	\$ 22,758	\$ 34,500		\$ 192,997	\$ 832	\$ 13,604	\$ 264,691
Special Revenue Fund	0	54,698		3,671	9,934,800	20,000	10,013,169
Enterprise Fund	<u>0</u>	<u>0</u>	\$ <u>4,533,391</u>				<u>4,533,391</u>
Unspent Budget Authority	\$ <u><u>22,758</u></u>	\$ <u><u>89,198</u></u>	\$ <u><u>4,533,391</u></u>	\$ <u><u>196,668</u></u>	\$ <u><u>9,935,632</u></u>	\$ <u><u>33,604</u></u>	\$ <u><u>14,811,251</u></u>

This schedule is prepared from the Statewide Budgeting and Accounting System. Additional information is provided in the notes to the financial schedules beginning on page A-15.

Notes to the Financial Schedules

For the Two Fiscal Years Ended June 30, 1996

1. **Summary of Significant Accounting Policies**

Basis of Accounting

The department uses the modified accrual basis of accounting, as defined by state accounting policy, for its Governmental, Expendable Trust, and Agency Funds. In applying the modified accrual basis, the department records:

Revenues when it receives cash or when receipts are measurable and available to pay current period liabilities.

Expenditures for valid obligations when the department incurs the related liability and it is measurable.

State accounting policy also requires the department to record the cost of employees' annual leave and sick leave when used or paid.

The department uses accrual basis accounting for Proprietary and Nonexpendable Trust Funds. Under the accrual basis, as defined by state accounting policy, the department records revenues in the accounting period earned if measurable and records expenses in the period incurred, if measurable.

Expenditures and expenses may include: entire budgeted service contracts even though the department received the services in a subsequent fiscal year; goods ordered with a purchase order before fiscal year-end, but not received as of fiscal year-end; and equipment ordered with a purchase order before fiscal year-end.

Basis of Presentation

The financial schedule format is in accordance with the policy of the Legislative Audit Committee. For audit reports issued after July 1, 1996 the Legislative Audit Committee approved a new financial schedule presentation for inclusion in agency audit reports. The schedules now include nonbudgeted revenue and expenditure activity and prior year revenue and expenditure adjustments for all financial schedules presented. In addition, financial activity for Agency

Notes to the Financial Schedules

Funds is included in the Schedule of Changes in Fund Balance and Property Held in Trust.

The financial schedules are prepared from the Statewide Budgeting and Accounting System without adjustment except for Agency Funds which are adjusted to reflect the additions and reductions to property held in trust. In cooperation with the Accounting Bureau of the Department of Administration, certain Agency Fund activity has been reclassified to the Expendable Trust Fund for financial schedule presentation. This activity includes:

- ▶ Corporation Tax to Financial Institutions
- ▶ Alcohol Tax
- ▶ Local Government Severance Taxes-Oil and Gas (Pre-1995)

Accounts are organized in funds according to state law. The department uses the following funds:

Governmental Funds

General Fund - to account for all financial resources except those required to be accounted for in another fund.

Special Revenue Fund - to account for proceeds of specific revenue sources legally restricted to expenditures for specific purposes.

Debt Service Fund - to account for accumulated resources for the payment of General Long-term Debt Principal and Interest. The department uses this fund for the deposit of money into the Long Range Building Program, the Coal Tax Bond Fund, and the Renewable Resource Bond Funds.

Capital Projects Fund - to account for resources used for purchase or construction of major capital facilities. The department uses this fund for the deposit of money into the Long Range Building Program.

Notes to the Financial Schedules

Proprietary Funds

Enterprise Fund - to account for operations (a) financed and operated in a manner similar to private business enterprises, where the legislature intends that the department finance or recover costs primarily through user charges; or (b) where the legislature has decided that periodic determination of revenues earned, expenses incurred or net income is appropriate. The department's Enterprise Fund contains the Liquor Division operations.

Fiduciary Funds

Trust Funds - to account for assets held by the State in a trustee capacity. The department's Expendable Trust Fund is used to account for unclaimed and escheated property, as well as the reclassified activity discussed above. Escheat property is property reverted to a governmental entity in the absence of legal claimants or heirs. The department's Non-Expendable Trust Funds include the Permanent Coal Trust Fund, the Coal Severance Tax Income and Bond Funds, the Resource Indemnity Trust Fund, the Common School Trust Fund, and the Treasure State Endowment Fund.

Agency Funds - to account for assets held by the State as an agent for individuals, private organizations, other governments or other funds. The department accounts for the protested rail road car company and property taxes in an Agency Fund. In addition, the 1995 production year was the last year for the Oil and Gas Severance Tax. Effective fiscal year 1995-96, the department assesses a combined oil and gas tax. These tax activities are accounted for in the Agency Fund.

2. Annual and Sick Leave

Employees at the department accumulate both annual and sick leave. The department pays employees for 100 percent of unused annual and 25 percent of unused sick leave credits upon termination. Accumulated unpaid liabilities for annual and sick leave are not reflected in accompanying financial schedules. In the Proprietary Funds, the increase in annual and 25 percent of the increase in sick leave are recognized as nonbudgeted expenses when the related liability is recorded at year-end. The department absorbs expenditures for termination pay in its annual operational costs. At June 30, 1995 and June 30, 1996, the department had liabilities of \$2,189,693 and \$2,114,747, respectively.

Notes to the Financial Schedules

3. **Pension Plan**
Employees are covered by the Montana Public Employees' Retirement System (PERS). The department's contribution to PERS was \$1,023,648 in fiscal year 1995 and \$1,168,809 in fiscal year 1996.
4. **General Fund Balance**
The General Fund is a statewide fund. Each agency does not have a separate General Fund since its only authority is to pay obligations from the statewide General Fund within their appropriation limits. Thus, on an agency's schedules, the General Fund beginning and ending fund balance will always be zero.
5. **Cash Transfers**
The Department of Revenue collects revenue for accounts administered by other state agencies. To move the cash collected to the administering, or spending agency, and to prevent recording revenues and expenditures twice, a cash transfer out is recorded on the department's records and a cash transfer in is recorded on the administering agency's record. Examples of cash transfers include statutory transfers of the accommodations tax, the nursing facilities fee, the university millage, highway reconstruction, permanent coal trust interest earnings, and the long range building program and the bond repayment accounts.
6. **Gain Contingencies**
Certain natural resource and corporation tax assessments are not reported on the department's financial statements because they are being protested administratively. As of June 30, 1996, the following assessments (by fund type) were outstanding (in thousands):

<u>Taxes</u>	<u>General</u>	<u>Special Revenue</u>	<u>Debt Service</u>	<u>Nonexpendable Trust</u>
Corporation	\$ 6,536		\$ 422	
Coal Severance	9,303	\$3,233	4,167	\$18,023
Oil and Gas	3,523			
Resource Indemnity		356		302
Totals	<u>\$19,362</u>	<u>\$3,589</u>	<u>\$4,589</u>	<u>\$18,325</u>

Collectibility of these amounts is dependent upon the decisions of the court, other authorities, or agreed upon settlements. Interest related to Corporation Tax assessments is distributed 100 percent to the General Fund.

Notes to the Financial Schedules

7.	Direct Entries to Fund Balance	The Schedule of Changes in Fund Balances and Property Held in Trust, contains direct entries to fund balances.
	General Fund	<p>Effective fiscal year 1995-96, the state school equalization aid account in the state Special Revenue Fund was eliminated. Prior to elimination, the account had a negative fund balance, requiring a General Fund transfer of \$6,739,624. In addition, the receivables established by the Office of Public Instruction for the proceeds of the school equalization aid levy in the amount of \$6,158,769 were transferred to the General Fund. These events created a net direct entry to fund balance of \$580,855 in fiscal year 1995-96, comprising 99 percent of the General Fund account total.</p>
	Special Revenue Fund	<p>Chapter 556, Laws of 1995, requires, unless otherwise specifically provided in the statutes pertaining to the tax, the portion of taxes collected by the state that, pursuant to a statute, are to be allocated or distributed to local government entities shall be accounted for in a fiduciary fund. As a result, residual equity transfers were recorded from the state Special Revenue Fund to a fiduciary fund, for portions of the Corporation Tax-Financial Institutions, Local Government Severance Tax-Gas & Oil, Alcohol Tax, and a portion of the Combined Oil & Gas Tax. This resulted in reducing fund balance by \$4,706,073 in fiscal year 1995-96.</p> <p>At fiscal year-end 1994-95, the school equalization aid account carried a negative fund balance. Prior to elimination, the state school equalization aid account required a General Fund transfer of \$6,739,624.</p> <p>Effective fiscal year 1995-96, the bond repayment account for the Old Fund Liability Tax (OFLT), was transferred from the state Special Revenue Fund to the State Fund enterprise account. This resulted in direct entries to fund balances in the amount of \$7,900,574 in fiscal year 1995-96.</p> <p>These three events comprise 99 percent of the Special Revenue Fund account total.</p>

Notes to the Financial Schedules

Enterprise Fund

The direct entries to fund balance of \$7,900,574 in the Enterprise Fund are a result of transferring the bond repayment account for the OFLT, from the state special revenue account, to the State Fund enterprise account in fiscal year 1995-96.

Expendable Trust Fund

The direct entries to fund balance in the expendable trust fund are the result of the reclassification of certain Agency Fund activity to the Expendable Trust Fund. At the direction of the Accounting Bureau of the Department of Administration, certain local assistance activity was reclassified. The direct entries to fund balance are the result of the residual equity transfers recorded from the state Special Revenue Fund for portions of the Corporation Tax-Financial Institutions, Local Government Severance Tax-Gas and Oil, and Alcohol Tax.

8. Benefits and Claims

Chapter 29 and 574, Laws of 1995, called for the department to refund to Montana taxpayers, a portion of the fiscal year 1994-95 budget surplus, exceeding \$21 million. The department made refunds to eligible income and/or property tax payers. The department views the refunds to be a one-time event.

9. Federal

In fiscal year 1995-96, the department recorded \$24,958,951 in U.S. Mineral Royalties in the General Fund. In prior fiscal years, the royalties were recorded by the Office of Public Instruction in the school equalization aid account.

10. Capital Project Fund Taxes

Effective July 1, 1995, 12 percent of coal severance tax collection is allocated to the Long Range Building Program in the capital project fund. In fiscal year 1994-95, these collections were allocated to the highway reconstruction account in the state Special Revenue Fund.

11. Nonbudgeted Activity

Effective fiscal year 1995-96, the department began recording the proceeds for the 40 and 55 mill levies on its financial records. In prior fiscal years this activity was recorded by the Office of Public Instruction. At fiscal year-end 1995-96, the department accrued revenue for the 40 and 55 mills totaling \$11,278,000. This activity is reflected as non-budgeted revenue to the General Fund, and accounts for over half of the difference between the actual tax

Notes to the Financial Schedules

revenue under estimated revenues. The remaining 40 and 55 mill levy proceeds collected during fiscal year 1995-96 are recorded as budgeted activity.

12. Budgeted Revenues and Transfers-In

Chapter 509, Laws of 1995, changed the agency which is responsible for recording the proceeds of the 40 and 55 mill levies. Effective fiscal year 1995-96 the department records this activity on its financial records in the General Fund. This activity was previously recorded by the Office of Public Instruction. This change resulted in approximately \$210 million additional revenue for the department in fiscal year 1995-96.

Legislation, effective January 1, 1996, significantly changes the calendar of business tax filings and payment of withholding taxes. The department approximates 2,900 employers will move to a weekly or bi-weekly remittance schedule, another 10,000 employers to a monthly remittance schedule, and the final 20,000 employers to an annual remittance and filing schedule. A result of accelerated filing/remittance is reflected in the increased tax revenues of approximately \$48 million in the General and \$1 million in the Debt Service funds in fiscal year 1995-96.

Chapter 556, Laws of 1995, requires the portion of taxes collected by the state that, pursuant to a statute, are to be allocated or distributed to local government entities shall be accounted for in a fiduciary fund. As a result, tax revenues previously recorded in the state Special Revenue Fund, are reflected in the agency and expendable trust funds in fiscal year 1995-96. This results in a decrease in state special revenue budgeted revenues in excess of \$41 million. In addition, in fiscal year 1995-96, the bond repayment account for the old fund liability tax transferred from the state Special Revenue Fund to the Enterprise Fund, impacting budgeted revenues by \$46.8 million in both funds. Also, the elimination of the state school equalization aid account impacted budgeted revenues and transfers in by \$9.4 million in the General and Special Revenue Funds.

Notes to the Financial Schedules

13. Litigation

Crow Tribe v. Montana, arose from a challenge to the Montana coal severance and gross proceeds taxes filed in 1978. The taxes were held preempted by federal law in 1988. The litigation presently is concerned with the claim of the Crow Tribe and the United States on the Tribe's behalf for restitution of \$46.8 million in severance taxes and \$11.4 million in gross proceeds taxes paid to the State and Big Horn County, together with prejudgment interest on those amounts. As of March 31, 1994, the Tribe and the United States estimated prejudgment interest due on the severance taxes at \$214.1 million and on the gross proceeds taxes at \$40.7 million. Trial on their claim was held in April and May 1994, and in November 1994 the District Court ruled in the State's favor. In August 1996, however, a three-judge panel of the Ninth Circuit Court of Appeals reversed the District Court's ruling and ordered restitution of the coal severance taxes. It further remanded the matter for determination of the claim to prejudgment interest. The State has petitioned for rehearing with a suggestion for rehearing "en banc" and, if unsuccessful, will seek review by the United States Supreme Court. The State believes there are substantial grounds for challenging the Court of Appeals' panel decision, but an unfavorable outcome is reasonably possible.

Albright, et. al. V. DOR, et. al. This case is a challenge to the constitutionality and legality of the Department's 1993 general reappraisal of all residential and commercial improvements and land. The district court on June 3, 1996, certified the case as a statewide class action. The Department of Revenue and the other seventeen named county defendants sought and the Supreme Court granted a Writ of Supervisory Control to review the class action issues. The result of this case could be that the 1993 appraisals and assessments as well as all subsequent property tax assessments are illegal.

On August 8, 1996, the Supreme Court issued an order declining to accept jurisdiction over the merits of the case and remanding the merits of the case to the District Court. On August 28, 1996, the Supreme Court heard oral argument on the class action issues, and issued an order on those issues. The Supreme Court reversed the

Notes to the Financial Schedules

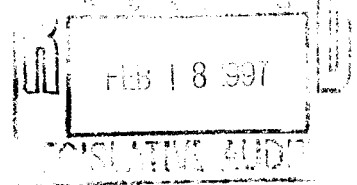
District Court holding the lower court's order allowing the blanket payment of taxes under protest was in error. The Supreme Court further ordered that any tax revenue being held in the counties' protest fund as a result of the blanket protest was to be disbursed.

The District Court conducted oral argument on the Plaintiffs' pending Summary Judgment Motions on November 1, 1996. On December 5, 1996, the District Court declared the 1993 reappraisal was unconstitutional. The District Court stayed the rule pending an appeal of the decision to the Montana Supreme Court. The Supreme Court agreed to hear the case on an expedited basis and has scheduled oral arguments for February 18, 1997. The State is not able to predict, at this time, the financial effect on the State and its local governmental units if the District Court's decision on the Computer Assisted Mass Appraisal System (CAMAS) is upheld and no assurance can be given that any such effect, if adverse, will not be material.

Agency Response

State of Montana

Marc Racicot, Governor



Department of Revenue

Mary Bryson, Director

P.O. Box 202701
Helena, Montana 59620-2701

February 11, 1997

Mr. Scott Seacat, Legislative Auditor
Legislative Audit Division
Room 135, State Capitol
P.O. Box 201705
Helena, MT 59620-1705

Re: Financial-Compliance Audit for Fiscal Years 1995 and 1996

Dear Mr. Seacat:

The Department of Revenue responses to the audit recommendations are as follows.

RECOMMENDATION #1

We recommend the department:

- A. Seek legislation to amend sections 15-36-324 and 325, MCA, which presently require deposit of state tax revenues in the Agency Fund.**
- B. Work with Accounting Bureau of the Department of Administration to ensure proper fund placement of local government assistance activity.**

Concur: The Legislative Finance Committee has House Bill 169 to amend section 15-36-324, MCA. We will request an amendment to include section 15-36-325, MCA. In addition the department will work with the Department of Administration concerning the proper fund placement of local government assistance activity.

Recommendation #2

We recommend the department implement a system to ensure agricultural lands are valued at 100 percent of productive capacity as required by state law.

Partially Concur: We agree agricultural lands are to be valued at 100% of productive capacity by state law. We do not believe the audit has demonstrated that the agricultural land is not valued at 100% of productive capacity.

Agricultural land is classified according to its use. Those five uses include:

- Non irrigated summer fallow farmland;
- Non irrigated continuously cropped farmland;
- Irrigated farmland;

Page B-3

- Non irrigated continuously cropped hayland; and
- Grazing land.

After the land is classified, a productive level, or grade, is determined. The grade is determined through interviews with the producer, interviews with surrounding property owners, a review of local federal government production levels, a review of soil surveys if available and information gathered from other private and public agencies. The last comprehensive statewide grading of agricultural lands occurred in the late 1970s.

Modern farming practices have changed the productive levels of some types of agricultural land over the last 20 years. Both irrigated and non irrigated farmland, in particular, have seen favorable increases in production. Some of that is due to management. In determining productive capacity of land, the department must judge what is average management and not penalize excellent management practices through changing property valuations.

Department staff has expressed the concern that some of the agricultural grades for these types of land may not reflect current productive levels. This concern was expressed to the Agricultural Land Valuation Advisory Committee when it studied agricultural land valuation prior to the 1993 legislative session. The committee chose to leave the land classes and grades as they have existed since the 1970s.

The 1993 Legislature established an interim committee to evaluate the irrigation factors included in the formula established by law in 1993. During the work of this interim committee, staff presented information about ways to update the agricultural land grades. The interim committee requested the 1995 legislature fund \$50,000 to examine new methods for determining agricultural land productivity in SB 198. The Senate Taxation Committee removed the study and the \$50,000 from the bill.

The process of agricultural land classification is extremely labor intensive. The current grades have been consistently applied from one parcel to the next, and from one county to the next. Thus, an equity exists among the agricultural land parcels of the state. The department has a responsibility to value all land equitably. Without a complete evaluation there is no guarantee of statewide equity. The department does not have the resources to do a complete evaluation of the existing agricultural land grades. Based on recent legislative action, the department believes it is complying with legislative direction.

Recommendation #3

We recommend the department ensure all financial information is considered in the preparation of assessments for centrally assessed properties by documenting the decision process for including or excluding financial information in the assessment of market value.

Concur: We agree all pertinent information must be considered in the appraisals of companies assessed by the Centralized Assessment Bureau and the decision making process for determining the valuation should be documented.

Recommendation #4 We recommend the department evaluate the implementation of its guidelines for verifying realty transfer certificates to ensure consistency throughout the state.

Concur: We agree.

RECOMMENDATION #5

We recommend the department transfer \$570,140 to the General Fund in accordance with section 15-35-108, MCA.

Concur: The Department has transferred \$570,140 to the General Fund. The department will transfer the entire cash balance to the General Fund at the end of fiscal year 1997.

Recommendation #6

We recommend the department tax intangible property in accordance with state law.

Concur: The Department will continue to examine areas of intangible property that may not currently be assessed for property tax. If a category of intangible property is determined to have an ascertainable value that is not being assessed for property tax, the Department will proceed cautiously in consultation with the Revenue Oversight Committee.

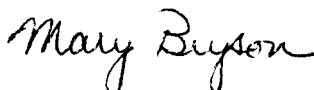
Recommendation #7

We recommend the department seek legislation to amend the distribution methodology outlined in section 15-36-324, MCA, to comply with the intent of the legislature.

Concur: A bill draft request has been submitted to amend 15-26-324, MCA to comply with the intent of the legislature.

Thank you for your courtesy on the audit.

Sincerely,

A handwritten signature in cursive script that reads "Mary Bryson".

Mary Bryson
Director